

General Information Letter: Application of the "paid in this State" principles to several examples.

January 12, 2005

Dear:

Your letter dated December 30, 2004 has been referred to the undersigned for a reply. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information, the regulation governing the issuance of letter rulings, 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department, can be accessed at the Department's website. That address is www.revenue.state.il.us/legalinformation/regs/part1200.

The nature of your question and the information provided require that we respond only with a GIL.

In your letter you state as follows:

My name is Ms. Z, and I work for COMPANY. We produce software that calculates and withholds income tax for nationwide clients. Our companies are large, multi-state employers with employees who may work in other states or who employ residents of other states. One of our clients has a question about the withholding of taxes for an **Illinois** resident working 50% of the time in **Illinois** and 50% of the time in another state. Additionally, our company is trying to obtain information on how **Illinois** taxes employees working in other states and the W-2 reporting requirements.

I have listed the four withholding scenarios that our company is interested in acquiring the answers for compliance purposes:

Scenario:

1. **Illinois** resident working in a state where the state's income tax is greater than **Illinois's** state income tax:

Question:

1. Is the income tax liability withheld, remitted and reported to the work state only, or does the employee have any tax liability for **Illinois**? On the W-2 form, is the income and withholding reported to **Illinois**, as well as the work state?

Scenario

1. **Illinois** resident working in a state where the state income tax is less than **Illinois's** state income tax.

Question:

1. Does the employer withhold solely to the work state, or is there also an income tax liability for **Illinois** for the remainder of the income tax? Is that due to **Illinois**? If so, what is the frequency for remitting the tax to **Illinois**? On the W-2 form, is the income and withholding reported to **Illinois**, as well as the work state?

Scenario

1. **Illinois** resident working in a state with no withholding tax:

Question:

1. Is the income tax due to **Illinois**? If so, what is the frequency for remitting and reporting the withholding due to **Illinois**? On the W-2 form, are the taxable wages reported to **Illinois**? Or are the taxable wages reported to the work state only?

Scenario

1. **Illinois** resident working part-time in **Illinois** and part-time in another state:

Question:

1. Does the employer withhold, remit and report to **Illinois** only those wages that are earned in **Illinois**? On the W-2 form, are the total taxable wages reported to **Illinois**, or only that portion earned in **Illinois**?

Department's Response

Please be advised that the general requirement to withhold Illinois income tax is set forth at Illinois Income Tax Act (IITA) section 701, which states in pertinent part as follows:

- (a) In General. Every employer maintaining an office or transacting business within this State and required under the provisions of the Internal Revenue Code to withhold a tax on:
- (1) compensation paid in this State (as determined under Section 304 (a)(2)(B) to an individual; or
 - (2) payments described in subsection (b) shall deduct and withhold from such compensation for each payroll period (as defined in Section 3401 of the Internal Revenue Code) an amount equal to the amount by which such individual's compensation exceeds the proportionate part of this withholding exemption (computed as provided in Section 702) attributable to the payroll period for which such compensation is payable multiplied by a percentage equal to the percentage tax rate for individuals provided in subsection (b) of Section 201.

(b) Payment to Residents.

Any payment (including) compensation to a resident by a payor maintaining an office or transacting business within this State (including any agency, officer, or employee of this State or of any political subdivision of this State) and on which withholding of tax is required under the provisions of the Internal Revenue Code shall be deemed to be compensation paid in this State by an employer to an employee for the purposes of Article 7 and Section 601 (b)(1) to the extent such payment is included in the recipient's base income and not subject to withholding by another state...

* * *

(d) Reciprocal Exemption.

The Director may enter into an agreement with the taxing authorities of any state which imposes a tax on or measured by income to provide that compensation paid in such states to residents of this State shall be exempt from withholding of such tax; in such case, any compensation paid in this State to residents of such state shall be exempt from withholding.

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Regarding "compensation paid in this State," IITA 304(a)(2)(B) states in pertinent part:

(B) Compensation is paid in this State if:

- (i) The individual's service is performed entirely within this State;
- (ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or
- (iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

In order to answer some of your questions, we assume that the Illinois resident employee is working in a state with which Illinois has not entered into a reciprocal agreement as referred to above at IITA 701(d). Also, regarding your first three questions, we are forced to assume that the Illinois resident earns his or her entire compensation income in a state other than Illinois (i.e., the one in which he/she works).

In answer to the questions raised under your first two scenarios, the Illinois resident would have no "compensation paid in Illinois" under the localization test of IITA 304(a)(2)(B). Furthermore, the example stipulates that the compensation income would be subject to withholding of income tax for the state in which the work was performed. This falls within the exception created by IITA 701(b) regarding withholding on payments to residents. Resultantly, there would be no Illinois income tax withheld from such compensation.

Regarding your third question, the facts are the same as the first two scenarios, but no foreign state income tax is withheld from the compensation. In such an instance, Illinois income tax should be withheld if withholding is required under the IRC and the employer maintains an office or transacts business in Illinois. Under either the localization test of IITA 304(a)(2)(B) or the payment to resident test of IITA 701(b), this compensation is deemed to be "paid in this State." As to the frequency of the remittances and reporting, that is determined by the amount of Illinois income tax withheld from wages by the employer in question. This information is contained in regulations promulgated by the Department at 86 Ill. Adm. Code 100.7000 et seq., which are accessible at the website mentioned above. We also enclose for your review the Department's IL-700 Booklet which discusses these same principles. Finally, since all of the wages would be considered "compensation paid in this State," under IITA 701(b), they would be reportable to Illinois on the W-2.

Regarding your fourth question, if withholding is required under the IRC and that the employer maintains an office or transacts business in Illinois, Illinois income tax should be withheld from the portion of the employee's income that is "paid in this State." For Illinois purposes, this is an all or nothing proposition, based on the localization rules provided. Thus, if all of the compensation earned by the employee is deemed to be "paid in Illinois" because, for example, the services performed in the other state are merely incidental to those performed in Illinois, the Copy B of Form W-2 issued for Illinois will show 100% of taxable wages as being reportable to Illinois for withholding purposes. Withholding rules differ among the states, however. Thus, it may be possible that an employee reporting 100% of wages to Illinois for withholding purposes will also be subject to withholding in the other state based on that state's law. In such a case, the employer would likely issue a second Copy B of Form W-2 showing that state's wages also subject to withholding under its particular formula.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and wish to obtain a binding private letter ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of 86 Ill. Adm. Code 1200.110(b). If you have questions regarding this GIL you may contact Legal Services at (217) 782-7055. If you have further questions related to Illinois income tax laws, visit our web site at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely yours,

Jackson E. Donley,
Senior Counsel-Income Tax